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In the Supreme Court of the United States

OCTOBER TERM, 1949

No. 214

UNITED STATES OF AMERICA, PETITIONER

v.

CUMBERLAND PUBLIC SERVICE COMPANY, A CORPORATION

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

The Solicitor General, on behalf of the United States, prays that a writ of certiorari issue to review the judgment of the United States Court of Claims entered in this case.

OPINION BELOW

The special findings of fact and opinion of the Court of Claims (R. 55-76), together with the dissenting opinion of Judge Madden (R. 76-77), are reported at 83 F. Supp. 843.

JURISDICTION

The judgment of the Court of Claims was entered on May 2, 1949 (R. 77). The jurisdiction of this Court is invoked under 28 U.S.C., Section 1255(1).

QUESTION PRESENTED

After it was agreed that the taxpayer corporation's property should be sold to a designated purchaser, and as part of a pre-conceived plan to avoid the imposition of the tax which would be incurred if the taxpayer sold its property directly to the purchaser, the stockholders caused the taxpayer's property to be distributed to them in a liquidation distribution, and, thereupon, they transferred the property to the purchaser.

The question is whether, contrary to the view of the Court of Claims, such a liquidation distribution can be utilized to relieve the corporation from tax where it serves no other purpose than to accomplish a circuitous routing of title from the corporation, through its stockholders, to the predetermined purchaser, all in accordance with a pre-conceived plan.

STATUTE AND REGULATIONS INVOLVED

INTERNAL REVENUE CODE:

SEC. 22. GROSS INCOME:

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the

transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

* * * * *

(26 U.S.C. 1946 ed., Sec. 22.)

TREASURY REGULATIONS 103, promulgated under the Internal Revenue Code:

SEC. 19.22(a)-19. *Sale of capital assets by corporation.*—If property is acquired and later sold for an amount in excess of the cost or other basis, the gain on the sale is income. If, then, a corporation sells its capital assets in whole or in part, it shall include in its gross income for the year in which the sale was made the gain from such sale, computed as provided in sections 111 to 113, inclusive. If the purchaser takes over all the assets and assumes the liabilities, the amount so assumed is part of the selling price.

SEC. 19.22(a)-21. *Gross income of corporation in liquidation.*—When a corporation is dissolved, its affairs are usually wound up by a receiver or trustees in dissolution. The corporate existence is continued for the purpose of liquidating the assets and paying the debts, and such receiver or trustees stand in the stead of the corporation for such purposes. (See sections 274 and 298.) Any sales of property by them are to be treated as if made by the corporation for the purpose of ascertaining the gain or loss. No gain or loss is realized by a corporation from the mere distribution of its assets in kind in partial or

complete liquidation, however they may have appreciated or depreciated in value since their acquisition. But see section 44 (d) and section 19.44-5. (See further section 19.52-2.)

STATEMENT

The taxpayer is a corporation which was engaged in the business of generating electricity and distributing it to retail consumers. All its capital stock was originally owned by three individuals, W. L. McComas, E. S. Mayes, and W. F. Grisby. McComas later transferred some of his shares in trust for certain members of his family, naming himself as trustee. Mayes acquired Grisby's shares and transferred some of his stock to certain members of his family. (R. 56.)

Tri-County Electric Membership Corporation, which will be referred to as Tri-County, was a cooperative corporation which was organized in 1936 and obtained electrical energy from the Tennessee Valley Authority for distribution. Part of its territory included the area served by the taxpayer. From the time of Tri-County's organization in 1936, it was its plan to acquire the taxpayer's transmission and distribution facilities, and it became evident to the taxpayer's officers that the taxpayer would either have to acquire power from the Tennessee Valley Authority or sell its properties to Tri-County. Negotiations to that end continued more or less regularly thereafter. In October, 1939, McComas conferred with a representative of the Tennessee Valley Authority to

ascertain whether the taxpayer could acquire power from the Authority, or, if not, whether a sale of its properties could be effected. The asking price for all the property was $156,000. Several months later, the representatives of the taxpayer met with representatives of the Rural Electrification Administration, called REA, to discuss the possibility of Tri-County's acquiring all the facilities of the taxpayer as a going concern, and offered to sell all the stock in the corporation at the price of $156,000. It developed, however, that there were certain facilities belonging to the taxpayer which Tri-County did not wish to acquire and also that a sale of the stockholders' stock would not be possible because REA would not finance such a purchase but would only finance Tri-County's acquisition of certain of the taxpayer's properties (R. 57-61.)

After an offer of $104,000 had been made for the designated portion of the taxpayer's properties which Tri-County wished to acquire, the taxpayer's officers employed a firm of certified public accountants to canvass the various tax consequences which would follow if the stockholders sold their stock, or if the taxpayer sold the properties in question, or if the taxpayer dissolved and distributed its assets to the stockholders followed by a subsequent sale of the properties by the stockholders. (R. 61.)

Subsequently, taxpayer's counsel wrote a letter to a representative of the REA, stating that

taxpayer's directors had determined that the taxpayer "will not accept an offer of $104,000.00 for the transmission and distribution lines;" the letter went on to say that McComas and Mayes "individually" would acquire the properties and would enter into a contract with Tri-County for their sale under certain prescribed conditions (R. 62-63.)

A formal contract was entered into between Tri-County and McComas and Mayes for the sale of the property to be acquired by the vendors from the corporation. The contract was dated June 10, 1940, but the signatures were actually affixed at a later date. (R. 64-65.)

On August 9, 1940, all the other stock of the taxpayer (except for qualifying shares) was transferred to McComas and Mayes who were to act as agents for the other shareholders in receiving their distributable portion of the taxpayer's assets. On August 13, 1940, at a special meeting of the stockholders, it was resolved that the taxpayer should be dissolved and, at a special meeting of the board of directors on the same day, McComas and Mayes were appointed as a committee to liquidate the corporation. (R. 65-67.)

On September 27, 1940, the Public Service Commission of Kentucky approved an application filed jointly by the taxpayer, Tri-County, and McComas and Mayes which stated that the taxpayer desired to dissolve, that its transmission and distribution system would be conveyed to McComas

and Mayes as a liquidation distribution, and that they would sell the property to Tri-County. (R. 67-68.)

On October 22, 1940, the taxpayer conveyed the property in question to McComas and Mayes who, on October 24, 1940, conveyed it to Tri-County. (R. 68.)

The Commissioner determined deficiencies in the taxpayer's income, declared value, excess profits and defense taxes for the calendar year 1940 resulting, in part, from his determination that the property in question had been sold by the corporation and that the resulting gains should have been included in its taxable income. After the asserted deficiencies had been paid, the taxpayer filed a timely claim for refund with the Commissioner of Internal Revenue. After rejection of the claim, proceedings were instituted in the Court of Claims to recover the refund. (R. 57-58.) The Court of Claims entered judgment for the taxpayer. (R. 77.)

REASONS FOR GRANTING THE WRIT

This case presents an increasingly familiar situation which frequently arises where the property of a closely held corporation is desired to be sold, and where the purchaser is unwilling to acquire the stock of the corporation, but is interested only in purchasing some or all of the corporation's property. If the corporation were to make the sale of its property directly to the pur-

chaser, it would be taxed on its gains and the stockholders might also be charged with taxable income whenever the proceeds are distributed by the corporation to them.[1] This, of course, is the normal incidence of the fact that Congress has seen fit to tax the corporation and its stockholders as separate entities. *National Carbide Corp.* v. *Commissioner,* 336 U. S. 422. After an agreement or understanding has been reached with a purchaser that the property will be sold, it has become the fashion to attempt to avoid the imposition of the tax on the corporation by going through the motions of having the corporation make a liquidation distribution of the property in question to the stockholders, who then sell the property as though they were the individual owners and vendors. A liquidation distribution to the stockholders is selected as one of the formalisms because, and only because, a corporation is not taxed with gain when there is a distribution of assets in complete or partial liquidation of the corporation,[2] and because the stockholders hope thereby

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[1] If the proceeds are distributed as an ordinary dividend, and if the corporation possesses earnings and profits to qualify the distribution as a dividend, the stockholder will be taxed with ordinary income. Section 115 (a), Internal Revenue Code. If the proceeds are distributed in liquidation, they may constitute capital gain to the shareholder to the extent that the payments received exceed his basis. Section 115 (c), Internal Revenue Code (26 U.S.C. 1946 ed., Sec. 115).

[2] See Section 19.22(a)-21, Treasury Regulations 103, *supra.* Similar provisions have appeared in all Regulations ever since Article 547, Treasury Regulations 45, promulgated under the Revenue Act of 1918.

to avoid the appearance of a transaction which would be taxable to the corporation, as would plainly be true in the case of a direct sale by the corporation made prior to or in the course of liquidation. The success of this tax avoidance scheme ultimately depends upon whether it was the purpose of the Regulations to relieve a corporation from tax where a liquidation distribution takes place, not to make the stockholders the owners of the property free to do with it as they please, but only to enable them to convey title to a third person in accordance with an agreement or understanding reached while the corporation still owned the property. It is the Government's position that in these circumstances the corporation has not made a non-taxable transfer of its property, and that it cannot be relieved from tax on the gains which inhered in its property, and which were realized upon sale to the ultimate purchaser.

1. The decision below is wrong. The Court of Claims, quite erroneously, assumed that the ultimate question depends upon who appears to be the formal vendor of the property. Because the stockholders and officers, in a deliberate attempt to avoid the imposition of the tax on the corporation, purported to act in their individual capacities in conducting some of the negotiations for the sale of the property while it was still owned by the corporation, and agreed, in advance, in their individual capacities, to sell the property after causing the corporation to distribute it by way of liqui-

dation, the court concluded that no gain could be attributed to the corporation. Inherent in this conclusion is the unexpressed assumption that the corporation made a genuine liquidation distribution which would relieve it from tax under Section 19.22(a)-21, Treasury Regulations 103, *supra*. This assumption and this conclusion are erroneous.

The provisions of the Regulations which relieve the corporation from tax when it makes a liquidation distribution to its stockholders, as is true of other provisions of the statute describing non-taxable situations, comprehend genuine transfers and not a series of formal steps designed to cloak what is in reality an altogether different transaction. Such has been the unvarying decisions of this Court. *Gregory* v. *Helvering*, 293 U.S. 465; *Minnesota Tea Co.* v. *Helvering*, 302 U.S. 609; *Griffiths* v. *Commissioner*, 308 U.S. 355; *Commissioner* v. *Court Holding Co.*, 324 U.S. 331. A genuine liquidation distribution which will relieve the corporation from tax can never occur when the stockholders are not intended to acquire unqualified ownership of the property, free to do with it thereafter as they please. It does not occur where, as here, the agreement to sell the property is reached when the corporation is the owner and the only entity capable of making the sale, and where the liquidation distribution can and does serve no legitimate business purpose, but for tax reasons is designed to make the stockholders appear as vendors following a transitory "ownership." *Kauf-*

mann v. *Commissioner* (C.A. 3d), decided April 26, 1949 (1949 C.C.H., par. 9268).

We contend that in the circumstances of this case no genuine, tax-free liquidation has occurred, and that the stockholders are mere conduits for the passage of title out of the corporation and into the predetermined purchaser. The same situation was presented in the *Court Holding Co.* case, *supra,* and when this Court said (p. 334) "A sale by one person cannot be transformed for tax purposes into a sale by another by using the latter as a conduit through which to pass title," it was applying the teaching of the above cited cases, particularly the *Minnesota Tea Co.* case, where the stockholders were also used as conduits between the corporation and its creditors to give the outward appearance of compliance with the non-taxable provisions which were there involved.

In the present case, negotiations looking toward the sale either of the stockholders' stock, or of the corporation's property, were started several years prior to the ultimate sale of the property. When it became clear that the stockholders' stock could not be sold and that the purchaser desired to acquire only part of the corporation's property, and when the negotiations were about to reach fruition, the taxpayer's officers and directors caused a study to be made of the possible tax consequences which would attend either a direct sale by the corporation, or a sale by the stockholders after acquiring the property through a liquidation distribu-

tion from the corporation. It was only thereafter that it was decided that the corporation would not accept any offer for its property, and that the stockholders should convey it after receiving it from the corporation.

We submit that the very matters on which the court below made the case turn demonstrate that this is a situation where the only permissible conclusion is that the gains are attributable and taxable to the corporation. Even if we accept the factual assumption of the court below that the corporation had not been a formal party to the negotiations and that the stockholders had purported to act for themselves, the very fact that the stockholders had agreed to sell the property to the purchaser at a time when it was still owned by the corporation (all in an admitted design to avoid the tax on the corporation) shows conclusively that the liquidation distribution was only employed to permit them to transfer title to the purchaser in accordance with an existing agreement. As the dissenting judge below pointed out, the liquidation distribution was a meaningless step, except as it was used in an integrated plan to accomplish, somewhat deviously, the desired end, namely, the transfer of the corporate property out of the corporation and into the ultimate purchaser. Such a liquidation distribution cannot disguise the fact that the corporation is the only vendor. Indeed, when the property of a corporation is sold, even in the course of liquidation, the

gains are taxable to it. Treasury Regulations 103, Section 19.22(a)-21, *supra*.

To hold, as did the court below, that a result contrary to *Commissioner* v. *Court Holding Co.*, 324 U.S. 331, is required in this case because, as it viewed the case, here the stockholders were cognizant of the tax consequences at the outset and were able to prepare their ritual before any part of the ceremony had commenced, rather than in the middle, as took place in *Court Holding Co.*, would make the tax results turn merely on how assiduously the formalisms are fully observed. Such a conclusion would be contrary to every basic principle ever pronounced by this Court. It is the corporation's property which is being sold and the corporation must be taxed with the gain (cf. *United States* v. *Joliet & Chicago R. Co.*, 315 U.S. 44); the stockholders and officers act for the corporation when they deal with its property whether they say so or not (*Kaufmann* v. *Commissioner* (C.A. 3d), decided April 26, 1949 (1949 C.C.H., par. 9268)). The corporation cannot avoid the tax by purporting to utilize the device of a tax-free liquidation distribution to its stockholders where that is only a means of accomplishing a sale of its property. *Kaufmann* v. *Commissioner, supra.*

2. An issue of considerable importance in the administration of the income tax law is raised by the present case. In *Commissioner* v. *Court Hold-*

ing Co., 324 U.S. 331, where the identical tax problem was presented, this Court held that (p. 334) "the Tax Court was justified in attributing the gain from the sale" to the corporation, and that the Court of Appeals had erred in arriving at the contrary conclusion. In so doing, the Court reiterated the principle that the true nature of the transaction cannot be disguised by mere formalisms designed to alter the tax liabilities imposed by Congress, that the various steps taken by the parties are not to be regarded as isolated transactions but must be viewed as a whole, and that a sale by one person cannot be transformed for tax purposes into a sale by another by using the latter as a conduit for passing title.

Ignoring these basic principles which underlie the *Court Holding Co.* decision, the court below has attempted to limit that case to its precise factual circumstances and has ruled that the opposite result is required if the negotiations are commenced by the stockholders when they purport to act for themselves instead of on behalf of the corporation. A similar decision was rendered in *Howell Turpentine Co.* v. *Commissioner*, 162 F. 2d 319 (C.A. 5th), where the Tax Court was reversed for having followed the *Court Holding Co.* decision. See also *Steubenville Bridge Co.* v. *Commissioner*, 11 T.C. 789, as an instance of where the Tax Court followed the wrong principles. Contra: *Kaufmann* v. *Commissioner* (C.A. 3d), decided April 26, 1949 (1949 C.C.H., par. 9268);

Wichita Term. El. Co. v. *Commissioner*, 162 F. 2d 513 (C.A. 10th); *Fairfield S. S. Corp.* v. *Commissioner*, 157 F. 2d 321 (C.A. 2d), certiorari denied, 329 U.S. 774.

These divergent views respecting the principles of the *Court Holding Co.* case which are to be followed by the lower courts make it a matter of prime importance that this Court should make it plain that *Court Holding Co.* was not a factual sport, but a decision resting on solid principles. The lower courts should be disabused of any notion that whether the stockholders or officers purport to act personally, or as representatives of the corporation, is a crucial matter on which the tax consequences can turn. It should be made plain that the *Court Holding Co.* decision did not invite the use of liquidation distributions as devices for tax avoidance when part of a preconceived plan to transfer the corporate property to a third party, and did not encourage an added formalism of pretending to lock the corporation's representatives out of the negotiation room in one capacity while admitting them in another.

3. As has already been made clear, the decision below conflicts in principle with *Commissioner* v. *Court Holding Co.*, 324 U.S. 331. The decision below also conflicts with *Gregory* v. *Helvering*, 293 U.S. 465; *Minnesota Tea Co.* v. *Helvering*, 302 U.S. 609; and *Griffiths* v. *Commissioner*, 308 U.S. 355, by holding that the corporation made a tax-

free liquidation distribution, when the distribution served no bona fide business purpose and when it was utilized only for the purpose of permitting the stockholders to transfer the corporation's property in order that it would appear, for tax purposes, that they and not the corporation were the vendors. The decision below is similarly opposed by the decisions of other courts of appeals rendered subsequently to the *Court Holding Co.* decision. *Wichita Term. El. Co.* v. *Commissioner*, 162 F. 2d 513 (C.A. 10th); *Kaufmann* v. *Commissioner* (C.A. 3d), decided April 26, 1949 (1949 C.C.H., par. 9268); *Fairfield S. S. Corp.* v. *Commissioner*, 157 F. 2d 321 (C.A. 2d), certiorari denied, 329 U.S. 774.

CONCLUSION

This petition for a writ of certiorari should be granted.

Respectfully submitted,

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Solicitor General.

JULY, 1949

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